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In Re:	**Application of the Workers' Compensation Rating and Inspection Bureau of Massachusetts for Approval of a General Rate Revision to be Effective on or after August 1, 1999**	**Division of Insurance Docket No. R99-34**

FINAL DECISION, FINDINGS AND ORDER

Dated: August 24, 1999.

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I. Introduction

In response to an order dated December 28, 1998 by the Commissioner of Insurance ("Commissioner"), the Workers' Compensation Rating and Inspection Bureau of Massachusetts ("WCRB") submitted a filing pertaining to workers' compensation insurance rates with the Division of Insurance ("Division") on March 1, 1999. This March 1 filing – subsequently amended with an assented-to supplement from the WCRB - contained a request for an average statewide increase of 2.6 percent in workers' compensation insurance premiums, to be effective August 1, 1999 ("WCRB filing"). The last decision on general rates for workers' compensation insurance was effective February 14, 1998 and approved a statewide average rate decrease of 21.1 percent.

By notice issued March 4, 1999, hearing on this rate filing was set for March 31, 1999. Pursuant to General Laws chapter 152, § 53A, the Commissioner is required to conduct a hearing to determine whether the classifications and rates proposed are "not excessive, inadequate, unfairly discriminatory to the risks to which they respectively apply and that they fall within a range of reasonableness." Accordingly, such public hearing was held at the offices of the Division of Insurance on March 31, 1999 to afford interested persons an opportunity to be heard on the WCRB's rate filing and to present testimony on workers' compensation insurance rates.

At the hearing, the State Rating Bureau ("SRB") was represented by John Lawlor, Esq. and Norma Brettell, Esq. The WCRB was represented by Scott P. Lewis, Esq. of Palmer and Dodge. Carolyn Boviard, Director of the Executive Office of Economic Development, Commissioner Campbell of the Department of Industrial Accidents, Denise Lucciola, Executive Director of the Massachusetts Workers' Compensation Advisory Council, Donald

Baldini, Senior Vice President of Associated Industries of Massachusetts, Daniel Cook of American Risk Management, Edward Gottlieb as attorney for CJP and Sons Construction Company, Stephen D'Amato, who identified himself as a "concerned citizen," Andi Kelsch, Assistant State Director of the National Federation of Independent Business, and John Spillane of the Massachusetts Marine Trades Association made statements at the public hearing.

A schedule of future proceedings was implemented at the close of this hearing. Pursuant to this schedule, the direct examination and cross-examination of the WCRB's witnesses began on April 14, 1999 with Howard Mahler. Mr. Mahler provided further testimony on April 15, 1999. Roy Stewart of the WCRB testified on April 21, 1999.

The SRB made its advisory filing on May 3, 1999, advocating for a 31.7 % decrease effective September 1, 1999. The direct examination and cross-examination of the SRB witnesses began on May 19, 1999 when Donald Bashline testified. The SRB's witnesses, Richard A. Cohn and Allan Schwartz, testified on May 20, 1999 and May 21, 1999 respectively.

The WCRB made a rebuttal filing on June 4, 1999. The direct examination and cross-examination of the WCRB's Howard Mahler occurred on June 18, 1999. The direct examination of Lawrence Kolbe occurred on June 24, 1999. The SRB waived cross-examination of Mr. Kolbe. The SRB made its surrebuttal filing on July 2, 1999. The subsequent testimony of Donald Bashline and Richard Cohn was taken on July 12, 1999 and Allan Schwartz' testimony followed on July 13, 1999.

With copies to the parties, the Workers' Compensation Advisory Council submitted written testimony, including an actuarial analysis performed by Ann M. Conway, FCAS, MAAA, of the firm Tillinghast-Towers Perrin, to the docket on July 14, 1999 pursuant to

General Laws chapter 152, § 53A(6)(b). The Final Briefs of the WCRB and SRB were filed on July 23, 1998.

II. Standard of Review

Massachusetts law provides that insurance companies offering workers' compensation insurance "shall file with the commissioner of insurance, or, if it is a member of or subscriber to a rating organization . . . , authorize such rating organization to file with the commissioner on its behalf, its classification of risks and premiums relating thereto and subsequent proposed classifications of premiums." G.L. c. 152, § 53A(1). "No proposed classifications or premiums shall take effect until approved by the commissioner of insurance as not excessive, inadequate, or unfairly discriminatory for the risks to which they respectively apply, and as within a range of reasonableness." G.L. c. 152, § 53A(7). If the Commissioner disapproves the rates proposed and concludes that any premiums currently in effect are excessive, the statute plainly states that the commissioner "shall order a specific decrease irrespective or [sic] whether any insurance company or rating organization has filed for a decrease in any premium rate." Id. at § 53A(8).

The WCRB is a rating organization duly licensed pursuant to General Laws chapter 152, § 52C. Its membership consists of approximately one hundred private insurance companies providing workers' compensation insurance in Massachusetts. The WCRB bears the "burden of furnishing evidence to enable the Commissioner to establish a range of reasonableness." Workers' Compensation Rating and Inspection Bureau v. Commissioner of Insurance, 391 Mass. 238, 245 (1984) (quoting Liberty Mutual Insurance Co. v. Commissioner of Insurance, 366 Mass. 38, 42 (1974)). See also Blue Cross and Blue Shield of Massachusetts v. Commissioner of Insurance, 420 Mass. 707, 709-10 (1995). "If the insurers fail to submit

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evidence sufficient to allow the [C]ommissioner reasonably to conclude, based on the evidence, that proposed rates will not be 'inadequate, excessive or unfairly discriminatory,' [she] may disapprove them." See Workers' Compensation Rating & Inspection Bureau v. Commissioner of Insurance, 391 Mass. at 245.

It is well-settled that the Commissioner or her designee, the Presiding Officer, has the authority to analyze each element of the rate filing and each method set forth in the rate filing and may reject the proposed rates if any element or method fails to meet the statutory standard. See Workers' Compensation Rating & Inspection Bureau v. Commissioner of Insurance, 391 Mass. at 264. Accordingly, the Commissioner or Presiding Officer may reject certain "elements of a filing" if they may lead to "rates falling within a range of excess, no matter how small." Id.

The statute does not require the commissioner to approve elements of filings which would lead to rates falling within a range of excess, no matter how small. The Commissioner's decision disapproving rates needs only to be reasonably supported by the evidence that the proposed filing will fail to produce rates which are not excessive, or will result in inadequate or unfairly discriminatory rates. Id. See also Blue Cross of Massachusetts v. Commissioner of Insurance, 397 Mass. 117, 119 (1986).

Moreover, the statutory grant is clear that "after the conclusion of a hearing on classification and premiums . . . [if] the commissioner of insurance determines that any already effective premium is excessive, he shall order a specific decrease in that premium . . . ." See G.L. c. 152, § 53A(8). Thus, the statute clearly envisions a process whereby a hearing on rates is completed, the filing is approved or disapproved according to the statutory standard and, if existing premiums are deemed excessive, an order may issue setting the specific rate decrease. See G.L. c. 152, § 53A. See also 1998 Decision on Rates ("1998 Decision") (decision utilizing

procedure not appealed). Such an ordered decrease would be effective six months from the date of the WCRB's March 1 filing – on September 1, 1999. See G.L. c. 152, § 53A(8).

III. Discussion

A. Net Trend

Workers' compensation insurance rates are a function of many elements. One important element is the so-called "net trend" - a concept that represents the relationship of the trend in premiums to the trend in losses. See 1998 Decision at 5. Although premiums and losses are trended separately, it is the relationship of the overall premium trend to the overall loss trend that is important for ratemaking purposes. According to the WCRB Final Brief, "[t]his year, the net trend debate centers on the projection of the trend in losses." See WCRB Final Brief at 8. The WCRB has recommended a net trend projection of +3.9 %. The SRB has recommended a net trend projection of -3.6 %.

As in previous filings, the two parties have argued for differing approaches in the calculation of trend. In simple terms, the WCRB has advocated the use of an econometric trend model with a thirty-year period (beginning in 1970) for calculating loss ratios. See Mahler Pre-Filed Direct Testimony at 15; Ex. 2 at 410. The WCRB model relies on Massachusetts employment levels one year prior to the projection period as the sole explanation of future changes in Massachusetts workers' compensation loss ratios. In utilizing thirty years of data, the WCRB made a corresponding estimate of the total effect of the 1991 Massachusetts Workers' Compensation Reform Law on loss ratios during that thirty-year period. The WCRB also used a "dummy" variable as a "subsidiary output, not used for any

purpose" in its model to adjust for improvements in cost containment from 1989 to 1998 by "backfitting the model when changes unexplained by employment take place." See Ex. 20 at 48; Ex. 21 at 4.

The SRB has used a historical extrapolation model that extrapolates trend from more recent experience.[1] See Ex. 6; Tr. 5-19, 5-21 [Bashline]. The SRB also used a selected 25 % estimate for the total impact of cost containment. See Ex. 6 at 12; Tr. 5-21 [Bashline].

It is common practice for actuaries to project future values by trending forward from appropriately adjusted historical experience. See Actuarial Standard of Practice No. 13. "In the absence of strong contrary indicators, there is a reliance on extrapolation of historical insurance data from the mathematical models." See Actuarial Standard of Practice No. 13; Ex. 6 at 14. In fact, the Division of Insurance has generally applauded this approach for workers' compensation insurance ratesetting in the last two fully adjudicated workers' compensation insurance rate decisions. "Trend refers to the projection of losses and premiums from *recent* policy and calendar year levels to the levels expected to prevail during the period for which rates are being set." See, e.g., 1987 Rate Decision at 41-56 (emphasis added); 1998 Decision at 6.

The WCRB has not demonstrated sufficient evidence that this practice should be changed in this particular ratesetting. Among other items, the WCRB's model uses employment level as the primary indicator of future workers' compensation loss ratios. See Ex. 2 at 411. However, it is reasonable[2] to assume that "numerous social and economic factors may affect the ratio of workers' compensation losses to premium - including, but not limited to, cost containment

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[1] The SRB's expert, Donald Bashline, conservatively used the five year period from 1993 to 1997 as the "most appropriate experience period to be used for these proceedings." See Ex. 21 at 16. There is a resultant –3.6 % net trend projection with this period. Conversely, "[u]se of the eight-year period from 1990 to 1997 would result in an SRB net trend projection of –6.9 %" using the same modeling. See id. The 1992 to 1996 period would have resulted in a –5.7 % projection.

activities by insurers, workplace safety, general price inflation and the administration of the benefit system." See 1998 Decision at 7. Accordingly, the WCRB has failed to establish that the precise model they proposed is grounded on a sufficient or reasonable causal relationship between employment and trends in workers' compensation loss ratios. See also generally Blue Cross of Massachusetts v. Commissioner of Insurance, 420 Mass. 707, 713-14 (1995) (mere speculation concerning matter of fact cannot form adequate foundation for Commissioner's decision); Massachusetts Automobile Rating & Accident Prevention Bureau v. Commissioner of Insurance, 389 Mass. 824, 845 (1983) (accord). In fact, the WCRB has also itself used a similar "recent-year" approach in its own past recommendations with respect to workers' compensation insurance rates.[3]

The WCRB has criticized the SRB net trend model as "untrustworthy" and "unreliable." Based upon a full review of the relevant evidence, however, this criticism is not well-taken. First of all, the SRB model includes a choice of parameters made to minimize model specification error. See Ex. 21 at 3. Conversely, the WCRB-created critique of the SRB model does not include considerations of such parameters. See Ex. 20 at 44-57; Ex. 20 at 4 (characterizing WCRB critique as "mindlessly applied mathematical exercise"). Moreover, the WCRB inconsistently argues that the SRB model is unresponsive to any alleged turning points while also suggesting it includes too-recent immature data. The SRB's witness has noted the inherent trade-off between responsiveness and reliability and stated, "The exact purpose of including 1997 data in the SRB model was to increase the chances of catching a possible turning point...." See Ex. 21 at 4.[4]

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[2] The many factors involved were, in fact, articulated in last year's rate decision. See 1998 Decision at 10-11.

[3] In the fully adjudicated 1987 proceeding, the WCRB accentuated recent historical data points. See 1987 Rate Decision at 43-44.

[4] The present record is not sufficiently developed to conclude that any such upward trend reversal has, in fact, occurred. The WCRB apparently has based its view that loss ratios have now changed on a slight upturn in PY1997 paid loss ratios. See Ex. 2 at 586. Mr. Bashline testified at even greater detail than noted here, "we

Each of these analytical points – taken individually - would be sufficient to demonstrate the unreasonableness of the WCRB model and the reasonableness of another model. Taken in whole, they advocate even more forcefully for a different model. The realistic statement made by the SRB's expert witness, Donald Bashline, FCAS, MAAA, FCIA, is repeated with favor:

> The construction of accurate trending procedures is a difficult task requiring all of the actuary's skill, especially in the dynamic environment of the Massachusetts workers' compensation system. This makes it all the more important that the procedure specify inputs and assumptions, and <u>demand evidence . . . of a change in trend direction before predicting one</u>. The WCRB trend methodology, with its abandonment of insurance data and refusal to specify key inputs, is unreasonable and the Commissioner must reject it. The SRB's methodology, while subject to all the sources of error of any regression methodology (including that of the WCRB) is constructed in accordance with actuarial standard of practice, using inputs that are the result of rational and expert judgment.

<u>See</u> Ex. 21 at 5 (emphasis added). In accordance with this quite credible statement, the WCRB's net annual trend figure is hereby disapproved as unreasonable, excessive and unsupported by the weight of the evidence.

The SRB's net annual trend was placed at –3.6 %. While the general direction of this trend prediction appears reasonable, the overall figure does not. In light of the "dynamic" nature of this modeling, there are concerns about providing insufficient weight to one necessary adjustment – the cost containment adjustment. <u>See</u> Ex. 6 at 11.

As the SRB itself has noted, "[t]he last ten years have brought about a revolution in workers' compensation claims management . . . in Massachusetts." <u>See</u> Ex. 6 at 11. The WCRB's own filing contains 1,041 page filing on cost containment alone in accordance with

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have . . . a series of loss ratios that are headed down and then one that turns up a bit....[T]he body of data that precedes [1997] needs also to be given considerable weight and with that weight I didn't think it was appropriate to infer a trend reversal [but] my inclusion of 1997 served to level off the trend line". <u>See</u> Tr. 10-20 and 10-21 [Bashline]. This appears to be a particularly sensible approach since the PY97 data should be reasonably considered but not "over-read" to suggest a reversal. <u>See</u>, <u>e.g.,</u> Tr. 10-20 and 10-21 [Bashline] (noting trade-off between reliability and responsiveness).

G.L. c. 152, § 53A(13). See Ex. 2 at 2010-2050. The SRB's expert has noted a range of reasonableness from 20 % to 37 %. See Tr. 5-22 [Bashline].[5] The 35 % figure appears to be a reasonable estimate of the effect of cost containment. First, it falls within the range of reasonableness suggested by the SRB's credible witness on net trend, Mr. Bashline. Secondly, it is more closely aligned with WCRB expert witness Howard Mahler's own account of overall loss ratio improvement at around 32 %. See Ex. 2 at 2044-2080 (noting Mahler and Blomstrom, Evaluation of the Qualified Loss Management Program for Massachusetts Workers' Compensation, Casualty Actuarial Forum (Winter 1999 ed.). Applying these figures to the otherwise approved trend analysis provides a net annual trend figure of -2.2 %. See Ex. 6 at 16, 19-20; see also Ex. 20 at 48. Accordingly, pursuant to G.L. chapter 152, section 53A, the net annual trend shall be set at -2.2 % and applied on a uniform basis throughout the trend period as a reasonable, adequate and not excessive figure.

B. Other Acquisition Expenses

In their pending filing, the WCRB has proposed that "other acquisition expenses" be treated as a fixed expense item rather than its customary treatment as a variable item relative to premium. See Mahler Pre-filed Direct Testimony at 18; Ex. 2 at 515; Tr. 11-5 [Schwartz]. The WCRB has identified these expenses as "the costs of acquiring business, writing and issuing policies, and collecting premium. See WCRB Final Brief at 13, 14 n.16. See also Ex. 2 at 515 n.5; Tr. 11-4 and 11-5 [Schwartz].[6] As its rationale, the WCRB has argued that

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[5] In fact, the SRB has cited, with favor, a Cost Containment paper co-authored by the WCRB's expert, Howard Mahler. See Ex. 6 at 12; Ex. 2 at 2044-2080.

[6] More specifically, the WCRB has defined "other acquisition expenses" as including "the expenses incurred in connection with such activities as: the soliciting and procuring of business; developing a sales staff; writing policy contracts; receiving and paying premiums and commissions; collecting premiums from agents or insureds; reconciling records relating to premiums; compiling expiration lists and notices of premiums due; preparation of

"[f]or a given volume of business measured in policy counts rather than by the amount of premium, other acquisition expenses would be expected to be about the same from one year to the next barring the effects of wage and price inflation. The large rate decreases that have occurred in the past several years would not be expected to have a significant, immediate impact on the allowance needed for other acquisition expenses." See Ex. 2 at 515-16.

The SRB's expert witness, Allan Schwartz, credibly noted that the WCRB previously advocated the opposite approach of making such expenses variable from 1988 to 1992 when, by all accounts, premiums were rising as well. See Ex. 21 at 30. But in an era of falling premiums, the WCRB has now argued for fixing such expenses. See id. at 31.

The WCRB's argument seems unreasonably end-result oriented, particularly in light of the comparison between premium and other acquisition expenses from 1988 to 1997. See Ex. 21 at 30-31; see also Ex. 30. Such a comparison demonstrates that the relationship was fairly linear (in the 2.5 % to 3.0 % field) until 1995, 1996 and 1997. See Ex. 21 at 30-31; see also Ex. 30. Even these three years are themselves relatively uniform, each settling around 4.5 %. See Ex. 21 at 30-31; see also Ex. 30. Allan Schwartz' analysis credibly indicates that any argument that there is an alleged upward escalation trend is more likely to be, as the SRB' Final Brief noted, "simply the artifact of a one-time increase in this percentage between 1994 and 1995." See Ex. 21 at 30. See also SRB's Final Brief at 64. While the longer-term average is 3.2 %, the SRB has advocated the use of the post-1994 level of 4.4 %. See Tr. 11 at 28 [Schwartz]; Ex. 6 at 85 n.12. This value appears reasonable. In contrast, the WCRB

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contingent commission statements; maintaining the goodwill of the insureds or producers; rendering services to agents and other producers; advertising and publicity relating to this expense group; quoting premiums; and signing policies." See WCRB Final Brief at 13, 14 n.16. See also Ex. 2 at 515 n.5; Tr. 11-4 and 11-5 [Schwartz]. The SRB's witness, Allan Schwartz, termed this definition "reasonable." See Tr. 11-5 [Schwartz]. The discussion herein is distinct from the expense constants analysis which follows.

has proposed the late 1990's annual inflation rate of 6.4 % as a fixed amount; this would result in a ratio of "other acquisition expenses" to premium between 6 % and 9 %.[7] See Ex. 21 at 31. As the SRB has posited, it would indeed be "quite imprudent" to discard "long-established methodology" in the present context. See SRB's Final Brief at 64 n.52.

Moreover, the present "variable" approach is consistent with prevailing actuarial standards of practice. See Ex. 6 at 85. Despite WCRB claims that the use of a "fixed" approach is likewise a commonly accepted actuarial principle, the SRB has significantly pointed out that the WCRB has not cited a single example "for workers' compensation, either in Massachusetts or anywhere else, to show that other acquisition expenses are treated as a fixed expense for workers' compensation ratemaking." See Ex. 21 at 31.[8] For all these reasons, I am persuaded that the WCRB's new proposal would lead to excessive provisions for "other acquisition expenses" and is unreasonable under the current factual setting.

C. Commission Expenses

The WCRB has stated that "[g]enerally, the provision for commission expenses in the rates covers the payments to agents and brokers for production, management, and other services when the payments are computed as a percentage of premium." See Ex. 2 at 520 (footnote omitted). Massachusetts General Laws chapter 152, § 53A(12) provides that the expense provisions on this matter must "be reasonable and ... reflect the actual cost to agents

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[7] The WCRB has seemingly relied upon a small portion of Mr. Schwartz' testimony as further support for the proposition that "other acquisition expenses" do not move in proportion to losses. See WCRB's Final Brief at 16; Tr. 11-6 [Schwartz]. However, any broad principle the WCRB may hope to glean from this one-line statement falls limply by the wayside in light of the full flavor of his testimony supporting retention of a variable expense item. See, e.g., 11-5, 11-26 to 11-32. See also Ex. 21 at 31.

[8] It is important to note here and on later points of contention that the SRB has, in fact, emphasized that "there are many differences in the ratemaking procedures used in Massachusetts for ratemaking for workers'

or brokers of the services they provide." See G.L. c. 152, § 53A(12).

The WCRB has proposed that the allowance for commissions be set at $64.9 million. See Ex. 20 at 64. The WCRB has acknowledged that this amount is higher than the average level for the most recent three years. See WCRB's Final Brief at 18. The WCRB has previously recommended an adjustment to the ratio of reported commission expenses to reported standard earned premium by putting the premium on a "net-of-deductible" basis. See Ex. 2 at 521. There are two further adjustments to the commission expense provision for use in 1999 proposed by the WCRB: (1) an adjustment to the calculated ratio "to account for the effect of company rate deviations" see Ex. 2 at 522; and (2) an additional adjustment to a higher commission expense provision of 7.5 %. See id. at 522-23. This last rise is proposed by the WCRB to account for three elements: (a) "increased competition among the carriers to write the business ... [which] has a tendency to increase commission rates;" (b) "the average dollar amount of commission paid per policy would" be unlikely "to decrease by" as much as the 21.1 % rate decrease of February 14, 1998; and (c) "as risks move into the voluntary market, the commission rates are expected to be higher" since "the percentage of business in the residual market has continued to drop since 1997 [and] [t]he commission rates for assigned rates are set at mandatory levels that are generally lower than the levels for voluntary risks." See Ex. 2 at 522-23.

The State Rating Bureau has argued that these adjustments are not reasonable. The SRB has effectively questioned the sufficiency of the evidence alleged to support the new calculations. Particularly, they critically examined the suggestion "that an upward adjustment

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compensation and private passenger automobile insurance, including in the area of expenses." See Ex. 21 at 31 n.8.

be made to account for expected future downward deviations" since it assumes that insurance companies would have paid higher commissions but for past deviations. See Ex. 6 at 85; Ex. 2 at 522. While this "deviation adjustment" may appropriately be the subject of further discussion in future years, the present record is insufficient to support this assumption. Such a change in methodology – as an upward adjustment distinct from the previously accepted methodology - should be made only after the credible presentation of evidence showing the relationship between commissions and downward deviations. See Massachusetts Automobile Rating & Accident Prevention Bureau v. Commissioner of Insurance, 389 Mass. 824, 845 (1983) ("mere speculation concerning a matter of fact cannot form an adequate foundation for the Commissioner's decision"). This is especially true in light of the precise statutory call for both reasonableness and a reflection of "the actual cost to agents or brokers of the services they provide." See G.L. c. 152, § 53A(12).[9] See also Ex. 6 at 86 and 86 n.16 (noting increased competition – and not "reverse competition" - may force commissions' costs down).

The State Rating Bureau has examined the last three years of available expense call data – 1995 through 1997 – when the commission percentages have been 5.29 %, 5.55 % and 5.76 % respectively and selected 5.55 %. The WCRB has instead calculated the average historical commission rate as 5.8 %. Either percentage (5.5 % or 5.8 %) would be within the range of reasonableness and in accordance with historically appropriate commission expense ratios, especially when viewed in light of 1993 through 1997 commission rates as presented by the parties. See Ex. 20 at 71; Ex. 6 at 86, 106 (1993: 3.53 %; 1994: 4.02 %; 1995: 5.29 % [using the higher SRB percentage]; 1996: 5.55 %; 1997: 5.76 %). However, the 5.8 %

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[9] Additionally, the SRB's expert witness, Allan Schwartz, has credibly illustrated that the WCRB has made "contradictory statements regarding the impact of competition on commissions." See Ex. 21 at 33. See also Ex.

commission rate is hereby adopted since it is also consistent with the values in place from the 1998 Decision which approved commission rates higher than the three-year average. See Mahler's Pre-Filed Direct Testimony at 17. Such a result also is based on Massachusetts data and is thus consistent with the well-heeded concern that this Division should not rely on countrywide data when competent Massachusetts data is available. See, e.g., Actuarial Standard of Practice No. 13, section 4.1; see also Ex. 6 at 56B.

D. Underwriting Profit Provisions

An underwriting profit provision "is based upon the discounted cash flow methodology developed for these proceedings" by Professors Myers and Cohn. See Ex. 2 at 631. This model acknowledges that a fair premium is "equal to the present value of the anticipated loss and expenses that must be paid, plus the present value of the income tax liabilities generated by the writing of the policy....The riskiness of the loss flows (which is very important in determining the shareholders' compensation in stock companies) is measured by discounting loss flows at a risk-adjusted rate ("CAPM")." See 1987 Decision at 85-86. While the WCRB and SRB have both utilized the so-called Myers-Cohn model to derive their calculations of underwriting profit in this year's proceeding, there is considerable disagreement between the two parties' conception of the liability beta, market risk premium and investment tax rate. Based on these different assumptions, the WCRB has proposed an underwriting profit provision of –1.7 % and the SRB has proposed a –13.2 % provision. See Ex. 2 at 631; Ex. 6 at 90. A point-by-point examination of the disputed points is necessary to analyze underwriting profit in this case.

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2 at 23; id. at 522.

1. Liability Beta

One major dispute centers upon conflicting conceptions of the so-called "liability beta." As in previously approved workers' compensation rates, the WCRB has again used a value of -.21 for its liability beta. See Ex. 2 at 733. The SRB has proposed a liability beta of +.13. See Ex. 6 at 58-63. It is undisputed that a positive liability beta has never been employed in setting workers' compensation rates. See, e.g., WCRB Final Brief at 24.

The Supreme Judicial Court has acknowledged that "money is made on investments, not on underwriting." See Massachusetts Automobile Rating & Accident Prevention Bureau v. Commissioner of Insurance, 381 Mass. 604-05 (1980). The beta of liabilities ("liability beta" throughout) "in the insurance rate setting context . . . is used as a measure of how investors view the specific riskiness of underwriting" insurance as compared to "investing in the average unregulated company." See Workers' Compensation Rating and Inspection Bureau v. Commissioner of Insurance, 391 Mass. 238, 258 (1984) (citation omitted).

Insurance companies offer two distinct opportunities within which investors may participate: (1) investment operations; and (2) insurance underwriting activities. See Ex. 20 at 96-97. The SRB has posited that underwriting provides "an opportunity to reduce risk" and should "result in a reduction in the rate of return". See Ex. 6 at 59. Use of a positive liability beta (and its concomitant negative risk premium) allegedly implies – in the SRB expert's own words - that "insurance activity is a vehicle for insurance company policyholders to reduce the risk of their overall investment portfolios. The insurance activity would act as a 'hedge' against stock market risk. As insurance company's shareholders . . . would be willing to accept a lower rate of return in order to benefit from the use of the insurance activity." See id.

However, the SRB has offered insufficient economic justification to support applying this critical concept in the present case. See, e.g., Ex. 6 and 20 ibid. Professor Cohn has instead characterized the calculation of a liability beta as "an empirical exercise." See Ex. 6 at 58. In fact, during an effective cross-examination, Professor Cohn testified that he had previously estimated liability betas of zero (1997) and -.15 (1993) in other ratesetting proceedings. See Tr. 6-69 to 6-70 [Cohn]. The WCRB has persuasively noted that Professor Cohn did not tie these shifting estimates to any observable changes in the economy, market fluctuations or insurance industry changes.

As consistently noted throughout this decision, formulations subject to conjecture are generally not a favored practice in the setting of Massachusetts insurance rates. See Blue Cross of Massachusetts v. Commissioner of Insurance, 420 Mass. 707, 713-14 (1995) (mere speculation concerning matter of fact cannot form adequate foundation for Commissioner's decision); Massachusetts Automobile Rating & Accident Prevention Bureau v. Commissioner of Insurance, 389 Mass. 824, 845 (1983) (accord). See, e.g., supra (WCRB addressing "well-founded concern" by introducing data into record of proceeding). See also 1998 Decision at 17. Rather, sufficient data exploring the attributes of the capital markets and the insurance business, including Massachusetts workers' compensation insurers, is needed for a more precise, grounded calculation. See also generally Ex. 21 at 31 n.8 (SRB noting differences between automobile and workers' compensation rate settings).

The testimony of Dr. Lawrence Kolbe was convincing and credible[10] on the deficiencies

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[10] The economist Dr. Kolbe's experience in this particular realm is impressive: "Over the last two decades, I have worked extensively in the area of risk and return, particularly for rate-regulated industries. I have co-authored two books specifically on this topic, . . . as well as more than thirty articles and studies. I have researched and worked on risk-return matters involving ten distinct rate-regulated industries on three continents, and I have addressed similar issues for a number of competitive industries as well." See Ex. 20 at 103.

of the SRB's positive liability beta as calculated.

> Professor Cohn's recommendation has the effect of granting companies that underwrite workers' compensation insurance in the Commonwealth a *negative* risk premium on that activity. That is, it has the effect of giving them *less* return on the equity invested in a risky activity, underwriting, than their shareholders (or policyholders, for mutual companies) could earn by putting the same money in no-risk U.S. Treasury securities. That is a unique outcome for a regulatory process, in my experience.

See Ex. 20 at 90 (emphasis in original).

Dr. Kolbe testified that he has "never before seen or heard of a regulatory body's concluding that a regulated company should earn a negative risk premium over Treasuries on the equity that underlies the business". See id. at 103-04. The WCRB, in fact, provided substantial data to reasonably demonstrate that no U.S. industry provides a negative risk premium. See Ex. 20 at 102-03; 120-26. Dr. Kolbe's testimony was not undercut by the SRB either in surrebuttal or during cross-examination.

Professor Cohn has alleged in the SRB's surrebuttal filing that his analysis would remain consistent with Dr. Kolbe's observations of "no industry negative equity betas" in light of his estimates of unlevered industry average equity beta from +.74 to +.92. See Ex. 21 at 15. This claim is not persuasive since an insurer's equity beta reflects results of two lines of business – investing and underwriting. See generally Massachusetts Automobile Rating & Accident Prevention Bureau v. Commissioner of Insurance, 381 Mass. 604-05 (1980); Workers' Compensation Rating and Inspection Bureau v. Commissioner of Insurance, 391 Mass. 238, 258 (1984) (citation omitted). An insurance company is distinguished as a potential investment by the existence of its underwriting functions. The question of whether a reasonable underwriting risk load exists cannot be answered by reference to the model company's positive equity beta overall, particularly when a negative underwriting risk load is

not demonstrated with credible data.[11]

The Supreme Judicial Court has previously acknowledged that "[n]o direct method exists for calculating the beta of liabilities for a particular line of insurance." See Massachusetts Automobile Rating & Accident Prevention Bureau v. Commissioner, 389 Mass. 824, 836 (1983). Dr. Kolbe expressed due caution when he observed that "if the models say [a negative equity risk premium], regulators should presume there is a mistake in the models or in their implementation." See Ex. 20 at 93. Based on a thorough review, the empirical methods employed by the SRB are not persuasive in the current dispute.

Professor Cohn derived estimates of the liability beta by solving the Fairley balance sheet equation given four required input parameters: the equity beta, the asset beta, the tax rate and leverage ratio. See Tr. 6-15 to 6-19 [Cohn]. The accuracy of any liability beta estimate is based on the accuracy of inputs and methods used to derive averages. There is credible reason to question these inputs and averaging methods as applied in this case.

It is undisputed that the input parameters and resultant liability betas would vary if the balance sheet equation were solved at a company-by-company level. See Tr. 6-53 to 6-55 [Cohn] and Ex. 8. This fact heightens the importance of the consistent use of properly weighted averages. Professor Cohn claimed his liability beta represented the weighted industry average. See Tr. 10-34, 10-82 to 10-84 [Cohn]. Yet the Professor did not derive the estimate by calculating liability betas and computing a weighted average. See Tr. 6-27, 10-34 to 10-37

[11] The SRB's claims would appear to suggest that investors are unaffected by underwriting risk load. This is not borne out by data and is inconsistent with the Myers-Cohn model. Moreover, the WCRB has not argued, contrary to Allan Schwartz' allegations, that the total risk of return would be expected to be less than the risk-free rate or that insurers would suffer operating losses under the SRB's proposal. See Ex. 21 at 37. Rather, the WCRB has credibly qualified its positive risk premium figure in the underwriting profit provisions as an incentive for subjecting capital to risk. Accordingly, any comparisons to observed total returns and NAIC profitability reports are not useful, particularly in light of the caveats employed therein. See Tr. 7-22 to 7-23.

[Cohn]; see also Ex. 6 at 60-63. Rather, he indicated he computed an average industry value using "weighted averages" or "expected values" for inputs. See Tr. 10-34, 10-82 to 10-84 [Cohn]. These "expected values" were not calculated averages but estimates, from a variety of sources, that were subject to Professor Cohn's judgment. See Tr. 10-34 to 10-37 [Cohn]; Ex. 6 at 60-63; Ex. 20 at 14-15 [Mahler]; id. at 107-110 [Kolbe].[12]

Professor Cohn's differing methods of selection for these different inputs involved several judgment calls which raise sufficient questions about proper weighting. Compare Equity Beta (Ex. 6 at 61) (using *unweighted* average values from *Yahoo!*, Value Line and Standard & Poors, *weighting* individual company betas *by* respective *aggregate market value*, *selecting* range for beta associated with property-casualty companies, then *unlevering* equity betas and *selecting* midpoint) with Asset Beta (Ex. 6 at 63 and Tr. 6-57 to 6-58) (using "flow of funds" from Federal Reserve Board, *assigning* different betas to various parts of the portfolio). Neither the asset beta nor the equity beta represent weighted averages of individual company observations.[13]

Based on these "adopted parameter estimates," Professor Cohn solved the Fairley balance sheet equation and computed a value of +.13 for the liability beta. See Ex. 6 at 63. Professor Cohn noted, somewhat significantly, that these estimates "imply" the presented liability beta and concluded, solely on the basis of this "empirical result," that this a reasonable and appropriate value for the liability beta.[14] See Ex. 6 at 63. Such a judgment-laden

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[12] Professor Cohn's own testimony – within the SRB's Advisory Filing – notes that "[I]n principle, the balance sheet equation calls for the use of weighted-average betas." See Ex. 6 at 61.

[13] Professor Cohn selected a value of 2 for the leverage factor or premium-surplus ratio after himself noting that Best's Average and Aggregates had reported a range of 1.82 to 2.68 for industry-wide premium-surplus ratios for the past five years. See Ex. 6 at 61.

[14] The WCRB's "box" example sheds more light on their argument on the inadequacy of Professor Cohn's "weighted averages." See Tr. 6-20 to 6-27 [Cohn]; Ex. 20 at 12-20; Ex. 21 at 10; Tr. 10-41 to 10-42, 10-34 to 10-37

"analysis" does not convey the due caution advocated by Dr. Kolbe. See supra.

Additionally, the WCRB plausibly called into question Professor Cohn's empirical methods by illustrating the profound effect on selections which one company, Berkshire-Hathaway, has. Berkshire-Hathaway's equity beta alone makes up 38 % of the total market capitalization of all companies in the Cohn sample. See Ex. 9; Tr. 6-44 to 6-47 [Cohn]. Yet Berkshire-Hathaway seems relatively uncharacteristic of typical insurers. In fact, this unique status is confirmed in an article which the SRB itself offered for the opposite proposition: Berkshire-Hathaway provides "virtually unlimited access to capital" and is "unlike most insurers, which live and breathe underwriting results". See Ex. 21 at 21 and 12. If one were to remove Berkshire-Hathaway from the data (and one assumed all other somewhat questionable estimates are true), there would no empirical "evidence"of a positive liability beta – it would be placed around zero. See Ex. 20 at 21 n.15. Professor Cohn admitted that he assumed his 29-company sample was representative without any investigation into the nature of the businesses or their investments. See Tr. 6-42 to 6-43. Such an insufficiently developed assumption of a major element in this case increases concerns about the overall reasonableness of the SRB's positive liability beta. See Massachusetts Automobile Rating & Accident Prevention Bureau v. Commissioner of Ins., 389 Mass. 824, 831 (1983) (citations omitted) ("any simplifying assumptions used in the [underwriting profit] model should not be 'fanciful or impossible to match in the real world").

[Cohn]. Simply put, when solving nonlinear equations, the average of solutions derived from individual observations will not always equal the solution derived from simple average observations. See Tr. 6-20 to 6-27 [Cohn]. Professor Cohn has admitted that the liability beta estimate is analogous to the estimate of the height of the boxes. See Tr. 10-34 to 10-37. Even assuming arguendo that Professor Cohn could come up with a weighting scheme required to "fix" the box problem, he admitted that he did not calculate average values for the input parameters using these weighted schemes – whatever the correct answer might be. See Ex. 6 at 60-63; Tr. 10-34 to 10-37 [Cohn].

Pursuant to Massachusetts General Laws chapter 152, section 53A, the full record of this proceeding indicates that a liability beta of -.21 is a reasonable, appropriate and not excessive figure for use in the present setting of Massachusetts workers' compensation rates. While certainly not dispositive, this decision notes that this is the same value which the Commissioner used for this figure within this industry's ratesetting a mere sixteen months ago. Perhaps more importantly, this figure is cognizant of the risk shareholders bear when they engage in the underwriting of insurance. This finding shall be applied in accordance with and consistent with the reasoning and analysis presented within this decision.

These findings do not imply – in any way – that a sufficiently and factually grounded and properly calculated positive liability beta may not exist and correctly be applied in a future proceeding. While positive liability betas are certainly possible as a matter of theory, the whole of this record simply does not allow for its adoption in this proceeding.[15] Anyone wishing to over-interpret this finding should be cautioned to note the above.

Similarly, persuasive arguments cannot be made for issue preclusion or that findings based upon the Division of Insurance's 1999 "auto decision" must be decided in similar fashion in the present forum.[16] First, the bare prerequisites for "official notice" have not met. See 211 C.M.R. 110.85(5); G.L. c. 30A, § 11 (requiring sufficient notice of issues involved for reasonable opportunity to prepare and present evidence or argument). As an additional matter, such findings are neither compelled by the relevant law or the present factual scenario.

A review of the law indicates that neither the Division of Insurance nor the parties to

[15] This remains particularly true in light of Professor Cohn's statement during cross-examination that he was presently unaware of any "reason to believe that the liability beta is the same for different lines of insurance." See Tr. 6-71 [Cohn].

[16] While this discussion is placed within the liability beta section since the SRB has urged these principles particularly with regard to underwriting profit provisions, it applies throughout this decision.

the 1999 workers' compensation ratesetting are precisely bound by any findings in the 1999 auto decision. See Tuper v. North Adams Ambulance Service, Inc., 428 Mass. 132 (1998) citing Fay v. Federal Nat'l Mtge. Ass'n, 419 Mass. 782, 790 (1995); Massachusetts Prop. Ins. Underwriting Ass'n v. Norrington, 395 Mass. 751, 753 (1985) (must be determination of final judgment on merits in prior adjudication; party against whom preclusion is asserted was a party or in privity; issues must be identical). This three-prong test is not satisfied. Leaving aside the 1999 auto decision's current status on appeal, the WCRB has never been a party to the automobile hearing and there is no privity. In fact, while some constituent companies of each groups may happen to be the same, the WCRB and the Automobile Inspection Bureau ("AIB") are not the same party. See also Massachusetts Prop. Ins. Underwriting Ass'n, 395 Mass. at 754 citing Sturbridge v. Franklin, 160 Mass. 149, 151 (1893) (not sufficient that they happen to be interested in proving or disproving same facts).

There is no identity of issues in the two proceedings. For example, Professor Cohn has stated that "[t]here is no reason to believe that the liability beta is the same for different lines of insurance." See Tr. 6-70 to 6-71 [Cohn]. See also Massachusetts Automobile Rating & Accident Prevention Bureau v. Commissioner of Ins., 389 Mass. 824, 836-37 (1983) (uncontroverted testimony that risk of underwriting varies among different insurance lines). Even assuming arguendo and dubitante that there is identity, the records developed on any of these issues, including rebuttal, surrebuttal and concomitant cross-examination, are quite different than that developed in the 1999 auto decision.[17] See also Ex. 21 at 31 n.8 (SRB noting "there are many differences" in ratemaking between workers' compensation and private

[17] Dr. Kolbe's testimony – as but one case in point – was wholly absent from the 1999 auto decision. Dr. Kolbe, an economist, expressed, in credible fashion, the need for due caution in this case.

passenger automobile insurance).

In addition, arguments remain unconvincing that this decision violates any of the Boston Gas decision's cautions for "reasoned consistency." The Supreme Judicial Court has significantly held that "[a] party to a proceeding before a regulatory agency such as the Department has a right to expect and obtain reasoned consistency in the agency's decisions. *This does not mean that every decision of the Department in a particular proceeding becomes irreversible in the manner of judicial decisions constituting res judicata, but neither does it mean that the same issue arising as to the same party is subject to decision according to the whim or caprice of the Department every time it is presented.*" See Boston Gas Company v. Department of Public Utilities, 367 Mass. 92, 98 (1975) (emphasis added). As noted previously, this is not the "same issue arising as to the same party" and, accordingly, "reasoned consistency" is present. "Reasoned consistency" would further only be violated should this agency find – for no reason – a different result. However, numerous reasons have been presented in the foregoing analysis gleaned from the precise record of this hearing.

2. Market Risk Premium

Another disputed input from the Myers-Cohn model is "market risk premium." This input measures the average premium investors expect when they invest in stocks rather than risk-free securities. See Ex. 6 at 64. The WCRB has used an estimated market risk premium of 9.4 % in its profit calculation based on a long-term (1926 to 1998) average of realized values published by Ibbotson Associates. See Ex. 2 at 735. The SRB has instead used a lower estimate of 7.1 % from this same source. See Ex. 6 at 64.

While the same genesis of data is used by both parties, the SRB's lower average results from a reliance on a series of values from 1960 to 1998. See id. The SRB's expert witness,

Richard Cohn, has explained that this shorter, more recent timeline is reasonable since structural changes in the American economy have made the earlier figures obsolete. See Ex. 6 at 64-67. Despite a relatively benign recount of American economic history from 1926 to the present, Professor Cohn has not offered any statistical data to support his textual passages.[18] Indeed, the WCRB has credibly shown that Professor Cohn has implausibly chosen a period which produces nearly the lowest possible result. See Ex. 20 at 42-43. Accordingly, the SRB's chosen value of 7.1 % is not a reasonable one.

The use of the long-term (1926 to 1998) average of realized values published by Ibbotson Associates is a longstanding mechanism employed in past Massachusetts workers' compensation rate decisions, including the setting of currently prevailing rates. There is a precise need for an enunciation of data and supporting argumentation when a change of methodology is advocated. See Blue Cross of Massachusetts v. Commissioner of Insurance, 420 Mass. 707, 713-14 (1995) (mere speculation concerning matter of fact cannot form adequate foundation for Commissioner's decision); Massachusetts Automobile Rating & Accident Prevention Bureau v. Commissioner of Insurance, 389 Mass. 824, 845 (1983) (accord). See, e.g., supra (WCRB addressing "well-founded concern" by introducing data into record of proceeding). See also 1998 Decision at 17. Use of the more restrictive but recent 1960 to 1998 data may, in fact, be a prudent methodology to employ in the future. It is certainly in keeping with the use of more recent data in the net trend calculation discussed above. However, the scant record offered in *this* proceeding cannot support its adoption in this case. Accordingly, the SRB is cautioned to introduce a complete set of data, including relevant

[18] For example, Professor Cohn has not demonstrated any meaningful data to contrast the period of the 1950's from that of the 1960's – instead he has relied upon merely his one-paragraph estimated account of investors'

market indices and econometric studies, supporting the use of the shorter time period of 1960 to 1998 prior to any possible adoption in the Massachusetts workers' compensation rate process.

Pursuant to Massachusetts General Laws chapter 152, section 53A, the full record of this proceeding indicates that the WCRB's chosen value of 9.4 % is a reasonable, appropriate and not excessive market risk premium figure for use in the present setting of Massachusetts workers' compensation rates.[19] This finding shall be applied in accordance with and consistent with the reasoning and analysis presented within this decision.

2. Investment Tax Rate

The WCRB and SRB further offer different federal investment tax rates ("ITR's") for use in the Myers-Cohn model.[20] The WCRB has used a rate of 35 %. See Ex. 2 at 729-30. This 35 % rate is based on an underlying assumption that the model company invests only in risk-free Treasury securities matched to the duration of expected cashflows. See, e.g., Ex. 2 at 729-30 (so-called "statutory/regulatory company assumption"). In contrast, the SRB has used an investment tax rate of 26.2 %. This 26.2 % ITR is alleged to "reflect a realistic investment portfolio based on an aggregation of the insurance industries' actual investment portfolios" (so-called "realistic portfolio approach" or "RPA"). See SRB Final Brief at 52-53. See also Ex. 6 at 67.

According to the WCRB, several points follow any assumption that the model insurer

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growing out of their depression-era fears. See Ex. 6 at 65.

[19] This finding rests entirely within the contours of the present record and is made within the context of the setting of Massachusetts workers' compensation rates as of September 1, 1999 pursuant to G.L. c. 175, section 53A. One may obviously – as with any fact-specific finding - argue the continuing sufficiency and applicability of this specific finding in any future proceedings.

[20] The parties both upwardly adjust their proposed tax rates by .2 % to reflect the impact of Massachusetts state tax on the investment income of domestic insurers.

invests entirely in taxable government securities: (1) the imputed investment income is determined by matching taxable government securities with investment cash flow; (2) the applicable tax rate to determine after-tax investment income should be the tax rate applicable to taxable government securities; (3) no adjustment for investment risk is made since the investment is "risk-free"; (4) a smaller allowance for investment expenses is appropriate since the model insurer would have smaller investment expenses than an insurer investing in a variety of assets (in fact, the WCRB has applied no allowance in its filing); and (5) no adjustment need be made to account for the Alternate Minimum Tax. See Ex. 2 at 729.

The WCRB has advocated that use of this statutory/regulatory assumption makes its measure "relatively stable and predictable" and "establishes an investment standard which real world companies can meet." See id. At 730. Moreover, it argues that such an ITR "insulates policyholders from the fluctuations in the stock and bond market to which they might be exposed if an actual portfolio model were used." See id. Simply put, the WCRB posits that "[t]he policyholder shares neither the risk nor the reward of any more risky investment strategy" and consistently, in its filing, there is no loading for investment expenses. See id. at 730 n.2.

The ITR has been explicitly and implicitly set in prior Massachusetts workers' compensation rate decisions. ITR's consistent with both approaches set forth above have been used previously in the Massachusetts workers' compensation setting. See 1987 Decision at 92 (employing WCRB-advocated 22 % tax rate – below the 34 % maximum corporate income tax rate); 1998 Decision (employing WCRB-filed ITR since noncontested issue).[21]

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[21] Notwithstanding the SRB's arguments, the fact that one particular approach was used – or not used – in the so-called 1999 Massachusetts "auto decision" has no necessarily preclusive effect on the current analysis which must

Richard Cohn, the co-author of the applicable Myers-Cohn model, has quite credibly noted that:

> The Myers-Cohn model specifies that policyholders should pay the insurer's taxes as a result of the fact that the business of insurance requires the corporate form of ownership. The effective investment tax rate is the portion of the return from investment that investors must give up as a result of corporate taxes on investment income. If investors receive more than this amount back from the policyholders, the result is that the investors are overcompensated for investment income taxes.

See Ex. 6 at 67. This statement seems particularly reasonable since the Myers-Cohn model implicitly requires policyholders to pay the entire load – whatever the investment - of investment income taxes through premium provisions, rather than just those taxes on exclusive investment in Treasury Securities. Accordingly, the WCRB's 35 % ITR – based on a model insurer's investments solely in Treasury securities – is unreasonable, excessive and unsupported by the record.

Richard Cohn's statement that "insurance companies do not pay taxes at a rate anywhere near the 35.2 % ITR recommendation of the WCRB" is credible and well-supported by a review of relevant data.[22] See Ex. 6 at 67. Professor Cohn calculated the effective tax rate by first adopting a 1998 Flow of Funds asset breakdown. See Ex. 6 at 68 and 78. Professor Cohn carefully selected the appropriate tax rates by asset class. Government and other taxable bonds were assigned a 35 % tax rate; tax-exempt bonds at 30.83 %; and stock /miscellaneous assets at 17.5 % to form a total tax rate of 25.48 %. See id. at 68 and 81.[23]

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rise or fall on its own specific facts. See SRB Final Brief at 53 inter alia. Similarly, any finding herein has no necessarily preclusive effect on any future analysis of this issue which must again rise or fall on its own specific facts. That is the nature of any litigated proceeding with precise factual data from a specific industry.

[22] Unlike other issues where the SRB has advocated changes in methodology without supporting data, Professor Cohn has provided a good deal of information to support his reasonable findings. Compare Ex. 6 at 64-67 and 80 (market risk premium discourse) with id. at 67-69 and 81 (investment tax rate analysis).

[23] Professor Cohn's care in selecting tax rates by asset class is borne out by a review of his calculations and corresponding explanations, including but not limited to his conservative acknowledgment of the Tax Reform Act

Conservatively rounded up to 25.5 %, Professor Cohn further made allowances for investment expenses (.5 %) and Massachusetts tax on domestic insurers (.2 %) to calculate the final 26.2 % "indicated tax rate." See id. Based on a comparison of this realistic analysis with the 35 % ITR, it is reasonable to find that the WCRB-selected value "would tend to result in overcompensation for the owners and excessive rates for policyholders." See Ex. 6 at 69.

The WCRB has not credibly challenged the underlying estimates or calculations and has never put forward alternative RPA calculations. The WCRB's remaining criticisms of the RPA approach are not reasonable and are not supported by the record.

The WCRB claims that the RPA approach is "internally inconsistent" with the Myers-Cohn model's assumption of a "risk-free" investment portfolio. But this critique does not consider the use of Myers' Theorem. As Professor Cohn has plausibly stated,

> There is no inconsistency. The Myers-Cohn model requires that policyholders pay the present value of all taxes, including taxes on investment income derived not only from policyholder funds but also from the allocated surplus funds. My implicit figure of \$20,631 has the same present value as the WCRB's \$13,938.

See Ex. 21 at 17. Within the SRB surrebuttal filing, Professor Cohn then derives Myers' Theorem:

> Thus it clearly makes no difference whether the expected risky-portfolio investment income tax is discounted at the appropriate risk-adjusted rate or, as the WCRB's implementation of the Myers-Cohn model proceeds, the tax on investment income calculated at the risk-free rate, r f, is discounted at r f. The statement in the rebuttal filing, at 21, that "Professor Cohn's and Mr. Schwartz' calculations are inconsistent with each other" is therefore false.

See Ex. 21 at 18. In addition, the nature of a present value model satisfies any purported need for an acknowledgment of the investment risk associated with insurers' asset portfolios. See

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of 1986 which had the effect of increasing the previously expected tax rate for municipal bonds from 27 % to 30.8 %. See Ex. 6 at 68-69 and 81.

Ex. 21 at 17-18.

While not quantifying an alternative figure, the WCRB claims that the SRB approach improperly ignores the Alternative Minimum Tax ("AMT"). See Ex. 20 at 21. However, Professor Cohn plausibly notes that the "22.5 % figure reflects the actual tax burden imposed on pretax equity; the figure therefore reflects the corporate alternative minimum tax (AMT) to the extent that it actually applies. Furthermore, while tax-exempt interest is a preference item under the AMT, the 26.2 % investment tax rate figure exceeds the tax rate that would be imposed on the investment income I use in my analysis under the AMT." See Ex. 21 at 19.[24]

Moreover, WCRB concerns that the SRB did not "see whether the SRB's model company had sufficient investment income taxed at 35 % in order to offset the underwriting losses" fall flat. See Ex. 20 at 21. No such requirement is needed since the Myers-Cohn model already presumes that an insurer is currently liable for taxes and does not benefit from a tax loss carryforward. See Ex. 21 at 19 n. 20.

The SRB has credibly shown that the 35 % ITR employed by WCRB is unreasonable and excessive and, consistently, that the "realistic portfolio approach" – with an indicated ITR of 26.2 % - is an appropriate and reasonable one to employ in this proceeding. This finding shall be applied in accordance with and consistent with the reasoning and analysis presented within this decision.

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[24] WCRB claims of an inconsistent average tax rate being employed in the profit provision calculations by Mr. Schwartz (8.2 %) and Professor Cohn (22.5 %) need not be discussed in light of previous findings not adopting Mr. Schwartz' profit proposals.

4. Calculation of Underwriting Profit Provision

Reasonable calculations based on the findings above applied consistently with other uncontested findings of the WCRB filing yield an underwriting profit provision of – 4.7 %. Pursuant to G.L. c. 152, section 53A, this figure is hereby adopted as a reasonable, adequate and nonexcessive figure for the reasons expressed above.

E. Cost Containment

The WCRB made a 1,041 page filing on cost containment in accordance with G.L. c. 152, § 53A(13). See Ex. 2 at 2010-2050. This section provides:

> "The commissioner shall make a finding on the basis of information submitted in any filing made pursuant to this section that the insurer or insurers employ cost control programs and techniques acceptable to the commissioner which have had or are expected to have a substantial impact on fraudulent claim costs, unnecessary health care costs, and any other unreasonable costs and expenses, as well as on the collection of the appropriate premium charges owed to the insurer or insurers. If the commissioner does not so find, the commissioner may disapprove such filing. The commissioner shall also have the authority to make findings, after a hearing on any filing made pursuant to this section, that the proposed rates or classifications are excessive and that the excess is due to the failure of the insurer or insurers to utilize adequate programs to control costs or expenses or to collect the appropriate premium charges. If the commissioner so finds, he shall disapprove such a filing or, in the alternative, shall limit in any manner he determines to be appropriate the amount of any adjustment in premium charges based upon changes in costs, expenses, and premium collections."

See G.L. c. 152, § 53A(13). The SRB has not offered any evidence contesting this lengthy filing other than an introductory reference in its Advisory Filing that "it expects to argue that the WCRB has not met its burden of demonstrating that the insurers are employing acceptable cost containment programs and techniques that have had or are expected to have a substantial impact on fraudulent claim costs, unnecessary health care costs, and any other unreasonable costs or expenses." See Ex. 6 at 2. Based on an in-depth review of the WCRB filing on cost containment and the complete absence of any alternative evidence, I hereby find that there are acceptable "cost

control programs and techniques" presently in place which satisfy the statutory requirements. As such, this Decision makes no adjustment to the WCRB's filing pursuant to G.L. c. 152, § 53A(13).[25]

F. Loss Constant

The loss constant component is a flat charge to employers evidently reflective of the proposition that small risks have higher loss ratios than large risks. See Ex. 2 at 1720-29. See also Tr. 2-58 [Mahler]. Currently, manufacturing employers have no loss constant added to their premium charges; a loss constant of $50 is charged to eligible risks in construction classes; and a $20 loss constant is charged to risks in all other classifications. See Ex. 2 at 1720-29. See also Tr. 2-57-58. Instead, the WCRB has proposed this year that loss constants be charged at $100 per risk across all classifications. See Ex. 2 at 1720-29. The WCRB has stated that this loss constant will be implemented on a revenue-neutral basis through the use of an offset, thereby not affecting total insurer receipts. See id. at 1720, 1723 n.13, 1725. The WCRB has alleged that such an application across classifications is necessary since "rates for small risks are inadequate in the absence of a loss constant [and] large insureds now subsidize this shortfall in small insured's rates." See WCRB's Final Brief at 47; Ex. 2 at 1720-22.

The SRB's expert witness, Allan Schwartz, credibly noted that the "impact of the WCRB's proposed change in the loss constant is sufficient to result in premium increases in the range of 80 % for some risks. In addition, when the WCRB's proposed increase in the loss constant and expense constant are considered together, the proposed impact is sufficient to result in a premium increase in the range of 100 % in some cases." See Ex. 6 at 89.

The record contains insufficient evidence from which to base these significant increases. This seems particularly true in light of the established concern that "changes in rate structure should not be abrupt." See 1998 Decision at 19 n.17. See also, e.g., Ex. 2 at 31 (WCRB declining to file for allegedly indicated surcharge "in order to avoid undue market disruption"). Despite a stated concern in such analyses expressed in last year's Decision, the WCRB has again failed to provide a meaningful loss development factor analysis by size of risk which would be extremely helpful to the calculation of loss constants. See generally 1998 Decision at 19. The WCRB has also not considered the effects of changes in classification pricing levels over time. The WCRB's notation that such classification data can never reflect the current class relativities "due to inevitable delays in collecting data" is not well-taken, especially since a historical analysis would be achievable and helpful to an evaluation of the proposed change. See generally Blue Cross of Massachusetts v. Commissioner of Insurance, 420 Mass. 707, 713-14 (1995) (mere speculation concerning matter of fact cannot form adequate foundation for Commissioner's decision); Massachusetts Automobile Rating & Accident Prevention Bureau v. Commissioner of Insurance, 389 Mass. 824, 845 (1983) (accord). Even based on the data which was provided[26], the SRB has made a credible suggestion that a lower loss constant could be sufficient to place "loss ratios of small risks in line with those of the market as a whole." See Ex. 21 at 35, 44.

Pursuant to Massachusetts General Laws chapter 152, section 53A, the full record of this proceeding indicates that the Loss Constants proposed by the WCRB in this proceeding are

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[25] This finding is not intended to have any preclusive effect on any other finding, adjustment or order made within this Decision as articulated within that element's particular analysis.

[26] This discussion assumes *arguendo* – and merely for illustrative purposes – that any small risks may be "out of line" with those of the market as a whole and makes no specific finding on this point due to the insufficiently developed record.

unreasonable, excessive and not supported by the record. Accordingly, I find that the currently existing loss constants shall remain in place in the manner presently applied as reasonable and adequate figures.[27] This finding shall be applied in accordance with and consistent with the reasoning and analysis presented within this decision.

G. Expense Constants

The WCRB has filed for an increase of the expense constants paid by employers. See Ex. 2 at 517. The expense constant is an expense paid by employers to account for the manual rate structure's asserted inability "to cover all the costs of issuing a policy for a very small employer." See WCRB's Final Brief at 51; 1987 Decision at 82. Currently, there is a charge of $100 for employers with premiums under $200 and a charge of $200 for employers with premiums over $200. The WCRB has filed for a 25 % increase in both categories: (1) $125 for smaller employers (a $25 increase per premium); and (2) $250 (a $50 increase per premium). See Ex. 2 at 517. The State Rating Bureau has also advocated for an increase in these categories – up to $105 and $210 respectively. See Ex. 6 at 87 (a 5 % increase). Any expense constants would be implemented on a revenue-neutral basis. See Ex. 2 at 517-18; Tr. 7-81.

The WCRB has calculated its proposed expense constants by trending forward expense constants derived from the NCCI 1991 calendar year database. See Ex. 2 at 517. See id. While this data is older than would be preferable, the WCRB plausibly explains away the "age" of the data in light of the uncontroverted fact that "the NCCI collects and analyzes operating expenses by size of risk at most once each decade" because of "the time and effort

[27] As in past years, a corresponding offset will be applied so that the effect will remain revenue-neutral.

required of the carriers to complete these studies." See Ex. 20 at 64. It should also be noted that the WCRB has addressed one noted concern within the 1998 Decision by introducing the data into the record of this proceeding. See 1998 Decision at 17. See also Mahler Pre-Filed Direct Testimony at 18; Ex. 2 at 4419-4430 (technical appendix within filing).

Notwithstanding these points, concerns enunciated previously about the NCCI data remain unanswered in this proceeding, demonstrating that the proposed expense constants are unreasonable and excessive. The WCRB's expert witness, Howard Mahler, has previously testified that this same NCCI study used a database in which Massachusetts data composed "a relatively small percent." See 1998 Decision at 17 (1997-98 testimony citation omitted). Additionally, this 1991 NCCI data wholly omits information from some of the largest Massachusetts workers' compensation carriers, including Eastern Casualty, AIM Mutual and Atlantic Charter. See id.[28] See also Ex. 2 at 732. Use of such data would run counter to the stated actuarial preference for "data generated by the book of business being priced." See, e.g., Actuarial Standard of Practice No. 13, section 4.1. See also Ex. 2 at 732. Moreover, the stated preference – in the future - for Massachusetts-based data would be entirely consistent with the WCRB's own well-articulated concern over "the time and effort required of the [obviously greater numbers of nationwide] carriers to complete these [nationwide] studies."

The WCRB is plainly wrong when it argues that the base would have to be 1991 instead of 1998's allegedly "stipulated values;" such values were not stipulated but were the subject of a decision in 1998 which emphasized the independent reasonableness of the expense constants so set. See 1998 Decision at 17. Accordingly, the base for trending should be the $100/$200

[28] In fact, Eastern Casualty leads domestic market share for 1997 with 10.17 %, twice that of any other domestic company. See Ex. 2 at 732.

values set in 1998.[29]

However, the WCRB's trend to be employed to the base is eminently reasonable. This trend figure of 7.1 % (using 4.6 % multiplied by 1.54 years; see Ex. 21 at 35) is plausibly and reasonably asserted to "reflect the composition of insurance company expenses and their inflation over time." See Ex. 2 at 518-19 and 540-45. See also Ex. 21 at 35. In fact, the SRB and WCRB have used this same trending factor for other purposes in this very case. See Ex. 6 at 95; Tr. 7-13 to 7-14 [Schwartz]. The SRB – in contrast – has employed a 5 % inflation rate to trend the expense constants forward without explaining why the so-called CPU-I inflation rate should be used to capture company expenses. Accordingly, the WCRB trend factors – as reflected in the second paragraph of page 35 of Ex. 21 - are to be applied.

Pursuant to Massachusetts General Laws chapter 152, section 53A, the full record of this proceeding indicates that the Expense Constants of $125 and $250 proposed by the WCRB in this proceeding are unreasonable, excessive and not supported by the record. Accordingly, I find that the expense constants to be used shall be the following reasonable and adequate figures:

[29] This does not settle whether, as Associated Industries of Massachusetts previously argued in the 1987 rate proceeding, that the "expense constant *must* take as its base for trending the prior approved level." See 1987 Decision at 83 (emphasis added). It merely finds that the 1998 base is a reasonable one from which to trend in this proceeding. This base is consistent with prior comments that one "credible source of guidance on this matter is the trend in expense costs since the last general rate revision." See 1998 Decision at 17.

(a) the expense constants for risks "developing less than $200 in Standard Premium" shall be calculated by employing a base of $100 and applying the trend factors as reflected in the second paragraph of page 35 of Ex. 21 to arrive at an expense constant of $107;

(b) and the expense constants for risks "developing at least $200 in Standard Premium" shall be set at $200 and applying the trend factors as reflected in the second paragraph of page 35 of Ex. 21 to arrive at an expense constant of $214.

These findings shall be applied in accordance with and consistent with the reasoning and analysis presented within this decision, including an appropriate offset to maintain revenue-neutrality.

H. Residual Market Surcharge

The WCRB has proposed a new 2 % residual market surcharge to account for the difference in experience between the residual and voluntary markets. See Ex. 2 at 30-31.[30] The WCRB's expert witness, Howard Mahler, has stated that the risks remaining in the residual market have "much worse than average experience." See Mahler Pre-Filed Direct Testimony at 5. The SRB has opposed such a surcharge. See SRB Final Brief at 78-81.

As the proponent of a new mechanism or methodology, the WCRB has the burden of proving its reasonableness. See, e.g., F.S. Royster Guano Co. v. Virginia, 253 U.S. 412, 415 (1919) (petitioner must demonstrate "reasonable ground" for classification of risk); Workers' Compensation Rating and Inspection Bureau v. Commissioner of Insurance, 391 Mass. 238, 245

[30] The WCRB and SRB have both noted a difference in the loss experience of the residual market and the voluntary market. See, e.g., Ex. 19; Tr. 7-66.

(1984) (quoting Liberty Mutual Insurance Co. v. Commissioner of Insurance, 366 Mass. 38, 42 (1974)). See also Blue Cross and Blue Shield of Massachusetts v. Commissioner of Insurance, 420 Mass. 707, 709-10 (1995). The WCRB has alleged that the surcharge is appropriate since the existing rating mechanism has created an asserted "structural subsidy" in the rates: insureds in the voluntary market allegedly pay more than required to support their own losses to make up for the costs of policies written in the assigned risk pool. See Ex. 2 at 30.

The WCRB, however, has not provided adequate support for its proposition that "because many insurers are seeking to expand their share of the voluntary market, the differential between the experience of voluntary market insureds and pool risks can be expected to increase." See Mahler Pre-Filed Direct Testimony at 5. The WCRB has offered insufficient analyses and underlying data for this premise.[31] See Ex. 6 at 91 (noting Risk Classification Statement of Principles and corresponding considerations).

The workers' compensation reform laws of 1991 gave the Commissioner the discretion to "establish rating plans which reasonably estimate the additional risk of business in the reinsurance pool." See G.L. c. 152, § 65C(2)(g) (as added by Chapter 399 of the Acts and Resolves of 1991). In the present proceeding – approximately eight years from the promulgation of this original statutory discretion - both parties have acknowledged that "market forces and other mechanisms and incentives have achieved a substantial reduction in the size of the pool." See, e.g., WCRB Final Brief at 56 (omitting interior quotation).

[31] Even assuming arguendo and dubitante the WCRB's allegation that the current rates are unfairly discriminatory, this alleged defect would not be solved by the WCRB's proposal for a 2 % surcharge since the WCRB has alleged that "as an actuarial matter...the surcharge should be set at about 19 %." See Ex. 2 at 31. Accordingly, even if one would agree with the underlying assertion that the current structure is unfairly discriminatory, the proposed solution would, by the WCRB's own testimony, be likewise unfairly discriminatory. See generally Century Cab Inc. v. Commissioner of Ins., 327 Mass. 652, 663 (1951) (nondiscriminatory charges equitably adjusted).

Indeed, the WCRB has not countered the fact that "the size of the residual market has dropped to 7 %, which is a lower share than anytime since at least as far back as 1980." See Ex. 6 at 90. Accordingly, the scant record of this proceeding does not indicate a sufficient basis to implement a novel policy never applied since the authority for a special pool rate was granted, especially when market conditions are "very substantially different (and better) than the conditions that gave rise to the grant of authority to apply that remedy." See 1998 Decision at 26-27. See also G.L. c. 152, § 65C(2)(g) (added by 1991 workers' compensation reform law).[32]

I. Capping

In their filings, the WCRB and SRB have both proposed caps of ± 25 % on changes in classification rates. See Ex. 2 at 1120; Ex. 6 at 107. However, the WCRB has proposed a traditional "cap" – using the law change plus half of the experience change as the mid-point of the "cap" interval. This method has been employed since at least 1975 and is "designed to moderate large changes in class rates in any one year." See Ex. 20 at 86. See also Mahler Pre-Filed Testimony at 23; Tr. 2-40 to 2-41 [Mahler]. The SRB has offered a different "cap": using the overall rate change as the mid-point of its capping interval. See Ex. 6 at 91.

The WCRB has credibly demonstrated that the SRB proposal has deficiencies and, accordingly, the traditional capping proposed by the WCRB is approved. In fact, the SRB has not provided any evidence of a jurisdiction that has adopted this novel approach. While it may be possible, the record remains unclear and undeveloped whether the cited Florida filing or the

[32] This decision further notes that reasonable incentives already exist for pool risks to seek voluntary coverage apart from any possible pool surcharge, including premium discounts and the availability of downward rate deviations. This finding is buttressed by the WCRB's own warning that this "decision reflect 'reasoned consistency' with previous decisions. Massachusetts Automobile Rating & Accident Prevention Bureau v. Commissioner of Ins., 401 Mass. 282, 287 (1987)." See WCRB Final Brief at 60.

unnamed filing "the NCCI recently made" have ever been approved. See Ex. 21 at 36, 45-46. Changing the cap mechanism in the face of what is mere speculation is not a favored practice. See generally Blue Cross of Massachusetts v. Commissioner of Insurance, 420 Mass. 707, 713-14 (1995) (mere speculation concerning matter of fact cannot form adequate foundation for Commissioner's decision); Massachusetts Automobile Rating & Accident Prevention Bureau v. Commissioner of Insurance, 389 Mass. 824, 845 (1983) (accord). This caution is buttressed by both parties' acknowledgment that "class capping issues are matters of public policy 'judgment'" entirely dependent "on the circumstances [and] facts in [each] case and what data were available, including the data that was available by classification." See Tr. 2-40 to 2-41 [Mahler]; Tr. 7-71 to 7-72 [Schwartz]. See also SRB Final Brief at 82 n.67.

Furthermore, the WCRB has effectively charted how the width band created by the SRB cap might provide "too much of a decrease . . . without allowing the rates of any class to increase, regardless of its experience." See Ex. 20 at 86 (charting 26 % increase in rates with SRB and WCRB caps). Indeed, the SRB's own expert witness, Allan Schwartz, has explained that its new proposal would subject individual insureds to very large "rate level changes." See Tr. 7-71 [Schwartz]. This is inconsistent with the Commissioner's concern that rate changes not be abrupt. See 1998 Decision at 17; 1987 Decision at 105. Accordingly, the WCRB approach reasonably sets classification swing limits in the present counters. See Ex. 20 at 86. See also Massachusetts Automobile Rating & Accident Prevention Bureau v. Commissioner of Ins., 401 Mass. 282, 287 (1987) (decision should maintain 'reasoned consistency' with previous decisions).

Pursuant to Massachusetts General Laws chapter 152, section 53A, the full record of this proceeding indicates that the classifications employed by the WCRB in this proceeding,

including the caps used, are reasonable. This finding shall be applied in accordance with and consistent with the reasoning and analysis presented within this decision.

J. Data Reporting Program

The SRB Advisory Filing asks that the Commissioner of Insurance institute a "data reporting" penalty program for workers' compensation rate setting purposes. See Ex. 6 at 92. The SRB has failed to set forth sufficient evidence for such a program to be implemented in the present case. The SRB has merely noted five alleged deficiencies (about 19 lines of text) within the 3,267 pages of the WCRB filing and rebuttal filing. See Ex. 2 and 20 (ibid.); SRB Filing at 84-85. Moreover, no further evidence was elicited on any of these alleged deficiencies during cross-examination of the WCRB's witnesses. See Tr. 2-63 to 2-64 [Mahler] (testifying merely that "most" states have some sort of data reporting program and "an appropriate penalty program would probably be preferable to no penalty program.") However, neither the precise counters of any proposed program nor any foreign jurisdiction's programs are recited by the SRB as evidence for the Commissioner's attention.

In light of this insufficient record[33], no specific program is hereby ordered in this proceeding. However, a data reporting program may be an important, effective tool in the future since timely-filed, accurate and complete data are the underpinnings of a reasonable, nonexcessive and adequate rate. See G.L. c. 152, § 53A. See also Workers' Compensation Rating and Inspection Bureau v. Commissioner of Insurance, 391 Mass. 238, 245 (1984) (Commissioner may disapprove rates if insurers fail to submit sufficient evidence).

[33] The full extent of the SRB filing on this point is contained within a four-sentence passage which asserts – without any further delineation – that the lack of a program is "contrary to the practice in other jurisdictions" and implementing such a program would "provide an incentive for insurance companies to report accurate data in a timely manner." See Ex. 6 at 92.

The legislature has conferred a specific statutory grant to the Commissioner for consideration of "reasonable rules and plans ... for the interchange of data necessary for the application of rating plans." See G.L. c. 175A, section 15. See also id. at section 16. See also generally G.L. c. 152, section 52C. In accordance with these statutory provisions, it is hereby ordered that the WCRB file a revised Statistical Plan for the Commissioner's consideration by February 15, 2000. Such a filing shall include a specific statistical data quality program with provisions for statistical submissions compliance and corresponding penalties and shall include supporting information, including examples of such programs in this or other jurisdictions for the Commissioner's review. The Commissioner will then review such filing pursuant to her statutory authority for its potential implementation.

IV. Disapproval of WCRB Filing and Order:

Pursuant to Massachusetts General Laws chapter 152, § 53A, the full record of this proceeding demonstrates that the filing of the WCRB contains "proposed classifications or premiums" which severally are "excessive," "unfairly discriminatory for the risks to which they apply" and are outside a "range of reasonableness" for the reasons expressed within this decision.

Since there has been "a conclusion of a hearing on classifications and premiums" and "the commissioner of insurance determine[d] that any already effective premium is excessive," the commissioner shall order a specific decrease in that premium to be effective six months from the date of the date of the insurance company or rating organization filing under consideration." G.L. c. 152, section 53A(8). See also 1987 Decision at 16; 1998 Decision at 30. Accordingly, the specific decreases ordered herein shall be effective on and after September 1, 1999 at 12:01 a.m.

The full record of this proceeding indicates that the overall average decrease in existing workers' compensation insurance rates shall be a 20.3 % decrease.[34] This decrease is consistent with and shall be made in accordance with the entire set of findings contained within the decision.[35] In the event that issues were not litigated or substantively addressed within the decision, the particular positions adopted within the WCRB filing in these regards hold true. See, e.g., SRB Final Brief at 87.

ORDERED this 24th day of August, 1999:

Michael T. Caljouw, Esq., Presiding Officer
Massachusetts Division of Insurance

AFFIRMED this 24th day of August, 1999:

Linda L. Ruthardt
Commissioner of Insurance
Massachusetts Division of Insurance

[34] Consistent with this decrease and the corresponding analysis contained within the decision, the D-Ratios to be used in the Experience Rating Plan for new and renewal policies effective on and after September 1, 1999 and Expected Loss Ratios to be used in the Experience Rating Plan for new and renewal policies effective on and after September 1, 1999 shall be calculated by applying the principles enunciated within this decision, including this decision's position on nonlitigated issues.

[35] Any proposed refiling in response to this decision will not be entertained in light of the clear statutory framework for establishing a specific rate decrease six months from the date of the original filing at issue.